REPORT BY THE

AUDITOR GENERAL

OF CALIFORNIA

THE PUBLIC UTILITIES COMMISSION COULD TRIM ADDITIONAL MILLIONS FROM TELEPHONE COMPANY RATE INCREASE PROPOSALS

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Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the Public Utilities Commission's reviews of telephone companies' rate increase proposals. The report shows that the commission's rate case reviews are not always well coordinated, accurate, or thorough. In addition, the commission missed an opportunity to reduce one company's rate increase proposal for underused telephone operating equipment.

Respectfully submitted,

THOMAS W. HAYES
Auditor General

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SUMMARY

The Public Utilities Commission's (commission) could improve the coordination, accuracy, and thoroughness of its telephone rate case reviews. Although the commission trimmed $924 million from the $1.6 billion rate increase proposals of the three telephone companies that we reviewed, the proposals could have been further reduced. These rate increase proposals were submitted by Pacific Bell, the General Telephone Company (GTC), and the Continental Telephone Company of California between 1983 and 1984. We estimate that more effective reviews could have saved ratepayers an additional $103 million in these cases: $73 million if the commission's reviews were more effectively coordinated, more accurate, and more thorough and $30 million if the commission had reduced the GTC's rate increase proposal because of the company's excess rate base. In addition, the commission cannot assure the necessity and reasonableness of millions of dollars of telephone company expenditures.

In addition to adjudicating major rate cases, the commission is involved in other telecommunications work. The American Telephone and Telegraph Company's divestiture has significantly added to the commission's workload. In addition to having to account for the divestiture during the Pacific Bell rate review, the commission has also had to resolve numerous other issues that have surfaced because of the divestiture. The commission is also active before the Federal Communications Commission (FCC), especially since the commission is concerned that the FCC is preempting the authority of state commissions in telecommunication regulation.

Rate Reviews Are Not Well Coordinated, Accurate, and Thorough

Rate case team members are not all using the same estimates for such items as inflation rates to determine telephone companies' revenue requirements. To ensure consistency and accuracy in their final estimates, team members are expected to use the same estimates for these and related items whenever possible. The team members are using different estimates because rate case managers do not always effectively coordinate team members' analyses, and team members do not always follow commission policy, which directs them to use each other's estimates in developing telephone companies' revenue requirements. For example, in the Pacific Bell rate case, a team member who analyzed the company's projected maintenance expenses did not use essential information developed by another team member. As a result, the team member overestimated Pacific Bell's revenue requirement by $33.8 million. Overall, as a result of inadequate coordination, the commission overestimated the revenue requirements for the three companies we reviewed by $41.3 million.

The team members sometimes use faulty analyses and make mathematical errors when developing their estimates. These inaccuracies are not detected because the rate case managers and supervisors do not always review team members' analyses and because the team members do not have enough computer resources to use when doing their calculations. For example, in the Pacific Bell rate case, a team member double counted some labor hours and made two significant mathematical errors when calculating his estimate of maintenance expenses. Consequently, his analysis overestimated Pacific Bell's revenue requirement by $11.6 million. In all, these types of inaccuracies led the commission to overestimate the revenue requirements for the three telephone companies we reviewed by $21.9 million.

The information on which the commission bases its decisions about rate increase proposals is not always complete. This condition exists because the telephone companies are not sufficiently documenting their need for rate increases, and the commission's auditors are not sufficiently reviewing telephone companies' accounting records. The commission has established standards that specify how major telephone companies are to justify their needs for a rate increase. However, rate case managers and supervisors do not ensure that the rate case team members enforce these requirements. Moreover, three of California's telephone companies are not subject to these standards or any other standards. Furthermore, the managers and supervisors do not ensure that the team members completely review telephone companies' accounting records to determine if costs are necessary and reasonable. As a result, the commission overestimated telephone companies' revenue requirements by $9.6 million. In addition, the commission cannot ensure that millions of dollars of telephone company expenditures are both necessary and reasonable.

The Commission Missed an Opportunity To Identify One Company's Excess Rate Base

In the GTC rate case that we reviewed, the commission overlooked the company's excess rate base. The commission does not have a formal method for determining which issues to investigate during a rate case. Rather, the rate case managers decide which investigations will be most beneficial to ratepayers. Even though the commission penalized Pacific Bell $47.5 million for inefficient use of its telephone switching equipment, the commission did not investigate this condition in the GTC rate case. We applied the methodology to the GTC rate case that the commission used with Pacific Bell and found that the commission missed an opportunity to save GTC ratepayers at least $30 million.

INTRODUCTION

The Public Utilities Commission (commission) is responsible for regulating privately owned public utilities and transportation companies. The commission's function is to ensure that safe and adequate gas, electric, telephone, water, transportation, and other services are available to consumers at rates that are fair to both the consumers and the companies. Rates must reflect the reasonable costs of a company's operations and include a fair rate of return on a company's investment. The commission regulates the rates and service of California's privately owned transportation companies and utilities, which include 22 local telephone companies and 81 long-distance telephone companies.

The commission is composed of five members appointed by the Governor and confirmed by the Senate for staggered six-year terms. Each year, commissioners elect one of their members to preside over decision-making conferences and other formal sessions. The commission appoints an executive director, who is responsible for the day-to-day operation of the commission and the supervision of over 980 staff members, including accountants, engineers, economists, and other professional and support personnel. The commission also appoints a general counsel, who is responsible for supervising the commission's attorneys. For fiscal year 1984-85, the commission had a budget of over $56 million.

The responsibilities of the commission are described in Article XII of the California State Constitution and the Public Utilities Code, Section 201 *et seq*. These responsibilities include setting utility rates, approving the operations of utilities, and monitoring utilities' operations for safety and quality of service. The commission also holds hearings to resolve consumers' complaints and to review subjects related to regulating utilities.

Rate-Setting Process

One of the commission's major responsibilities is establishing the rates that utilities charge consumers. In establishing utility rates, the commission considers the overall financial picture of the utility, the return on investment needed to attract investors, and the consumer, who is interested in the lowest possible rates. The commission is charged with balancing these interests to ensure that rates are fair and reasonable.

Until 1984, the commission accepted rate applications every two years from major telephone companies (Pacific Bell and General Telephone). Currently, however, these companies are filing general rate increase proposals every three years and can expect a commission decision within approximately one year. In applying for a rate increase, it is the company's responsibility to show that, at its present telephone rates, it cannot earn sufficient revenue to cover its costs of providing service and have the opportunity to earn a

reasonable return for its shareholders. A company's general rate application includes the company's latest financial statements, a schedule of the company's current rates, a statement of the company's proposed rate increases, a general description of the company's property and equipment, and a summary of earnings for the "test year"--the year upon which the company bases its justification for an increase. Rather than basing a rate increase solely on historical data, the company and the commission rely on "forward test year ratemaking," estimating the company's revenue needs for the year ahead, when the new rates will go into effect.

The commission's review of a company's application involves a critical analysis of the company's revenue estimates, operating expenses, depreciation expenses, and investment in plant and equipment. The commission is also responsible for reviewing the efficiency of a utility's operations and determining whether the company is providing adequate and reliable service.

In reviewing the company's application, the commission 1) establishes the company's rate base, 2) determines a reasonable rate of return, 3) assesses the reasonableness of the company's operating expenses, 4) decides how a rate increase should be spread among various classes of customers, 5) audits the company's financial records, and 6) assesses the quality of service that the company provides its customers.

In calculating the company's "rate base"--the book value of the company's plant and equipment--the commission adds up the original cost of all the company's plant and equipment and then subtracts the accumulated depreciation. Determining a company's rate base is an essential step in reviewing a company's application because a company's rate of return is computed from the company's rate base and is expressed as a percentage of the rate base. A company's rate of return covers the interest on borrowed funds, the dividends on preferred stock, and a reasonable allowance for a return to the company's stockholders.

Next, the commission determines the estimated operating expenses it will approve for the company. These include wages, taxes, supplies, depreciation, and other ongoing expenditures. At this point, the commission will have estimated in dollars the utility's annual gross revenue requirement--the amount the company is entitled to receive. This estimate equals the total of the company's rate of return, applied to its rate base, plus its allowed operating expenses. Once the commission establishes a company's gross revenue requirement, the commission must then decide how the rate increase should be applied to the company's various classes of customers--residential, agricultural, commercial, industrial, wholesale, and subclasses within each.

As part of each rate review, the commission also performs an audit of the financial and accounting records of the company. This

audit includes a review of selected rate base and operating expense accounts. The auditors also evaluate the financial impact of events outside the normal course of the company's operations, such as accounting changes ordered by the Federal Communications Commission or the deregulation of customers' telephone equipment.

Finally, the commission investigates the company's quality of service. To do this, the commission first reviews the company's performance against nine specified measures of service. In addition, the commission gauges the effectiveness of any of the company's special programs designed to address past problems. The commission also reviews the results of customer opinion surveys that the company administers.

The commission processes the applications of Pacific Bell and the General Telephone Company in accordance with the rate case plan. The rate case plan sets forth the schedule for the rate case review. This plan establishes deadlines for the reports and the written testimony submitted by the commission and the company; it sets the dates for the public hearings, which are typically a part of major rate cases; and it specifies the documentation standards that the commission requires companies to follow in justifying their need for rate increases.

The public hearing is an important component in the review of a utility's application for a rate increase. After a company files an

application for a general rate increase, the commission schedules a public hearing. Hearings are scheduled to allow all interested parties time to study the exhibits and the testimony presented and to prepare cross-examinations and their own testimony. In a general rate case, the hearings are presided over by an administrative law judge and usually begin with the applicants' explaining the reasons they need an increase in rates. Company officials testify as to the utility's investment in plant and equipment, its actual and requested earnings, and its revenues and operating costs. These witnesses may be questioned and cross-examined by the public and by a commission attorney. Commission staff may challenge any statement or utility claim they do not believe to be accurate or justified and may present evidence of their own on all issues. At some point during the public hearings, all interested parties are heard. Testimony presented during the hearings constitutes a major portion of the evidence in a rate case. The record of all facts put into evidence is the basis for the decision by the five commissioners.

Between March 1981 and June 1985, 24 of California's telephone companies filed one or more applications with the commission to increase the rates they charge their customers. Thus far, the commission has issued decisions on 34 of these applications, granting $1.41 billion in rate increases, of $3.28 billion requested.

Other Telecommunications Activity
<u>of the Public Utilities Commission</u>

In addition to adjudicating major rate cases, the commission is involved in other telecommunications work. Since the American Telephone and Telegraph Company's (AT&T) divestiture, the commission has been active on numerous other telecommunications issues. For example, the commission has issued several telecommunications decisions that did not involve a comprehensive rate review but dealt with the effects of the AT&T's divestiture. The restructuring of the telecommunications industry brought about by the divestiture raised a new set of issues that the commission has had to deal with. One such issue involves the desirability of allowing intrastate competition among long-distance companies. Under the terms of the AT&T's divestiture, telephone exchange areas known as local access and transport areas (LATAs) were created. California has been divided into 11 LATAs. Since the divestiture, Pacific Bell (formerly Pacific Telephone & Telegraph Company), now referred to as a local exchange company, can provide service only within LATA boundaries; the AT&T and other long-distance companies provide service between LATAs. For example, the AT&T and other long-distance companies provide long distance service between San Francisco and Sacramento; however, Pacific Bell is prohibited from providing this service because these two cities are in different LATAs.

In a 1984 decision, the commission permitted competition among long-distance providers in California, recognizing that the divestiture

agreement between the AT&T and the United States Department of Justice anticipated a competitive market for such services. However, to preserve universal service, the commission prohibited competition in the provision of local, or "intraLATA," telephone service. Since the 1980 census shows that almost 95 percent of California households have telephone service, the commission concluded that the intraLATA market should be left in the monopolistic control of the local exchange companies.

Another issue that has surfaced since divestiture involves a new service that Pacific Bell applied to the commission to provide--"exchange access." Exchange access is any activity that Pacific Bell provides to originate and terminate calls between telephone customers residing in different telephone service areas. The charge associated with this new service is referred to as an access charge. After divestiture, Pacific Bell argued before the commission that because it lost a segment of its long-distance business, it also lost a segment of revenue that helped it cover its cost of providing local telephone service. To compensate for the loss of long-distance revenue and to comply with the terms of divestiture, Pacific Bell applied to the commission for authority to impose this new access charge. In responding to Pacific Bell's application, the commission was faced with deciding not only an appropriate charge for this new service but also who would pay: the long-distance companies, the telephone customer, or both.

Also, in 1984 the commission implemented the provisions of a law enacted by the California Legislature--the Moore Universal Telephone Service Act--in response to concern over rising local telephone rates. The Moore Act required the commission to establish the manner in which California telephone companies would provide telephone service at reduced rates for residential customers of low and moderate income.

The Public Utilities Commission and the Federal Communications Commission

In addition to conducting major rate reviews and investigating the impact of significant structural and technological changes in the industry, the commission is also active in Washington, D.C., with the Federal Communications Commission (FCC), the United States Congress, and the United States Supreme Court. One of the commission's ongoing concerns is that the FCC is preempting the authority of state commissions in regulating the telecommunications industry. At one time, the respective jurisdictions of the state commissions and the FCC were quite clear. The FCC regulated interstate telephone service, and the state commissions regulated intrastate telephone service. However, the commission believes that, over the past 20 years, a variety of FCC decisions have eroded the jurisdictional lines between the respective agencies.

According to commission staff, the FCC is continuing to preempt the commission's authority in several areas. These include the

procedures used to depreciate telephone company assets, the regulation of mobile communication networks, and even the regulation of local telephone service. For example, the commission is fighting a 1981 FCC rule change on the depreciation of telephone company plant and equipment. Before this rule change, the state regulatory agencies set depreciation rates for that portion of a telephone company's assets allocated to intrastate service, and the FCC set rates for the assets allocated to interstate service. Under this arrangement, the state and federal authorities did not have to agree on each other's depreciation rates. However, under the new rule, the FCC has required that the state regulatory agencies establish depreciation rates that are consistent with those of the FCC. The commission's appeal of this decision is currently before the United States Supreme Court. In its appeal, the commission argues that the FCC rule change preempts the State's regulation of intrastate telecommunications services. If the court lets this FCC decision stand, the commission believes that it will be vulnerable to FCC preemption in other areas of telecommunications regulation as well.

SCOPE AND METHODOLOGY

The objective of our audit was to test the effectiveness of the Public Utilities Commission in critically reviewing telephone company rate proposals.

To evaluate the commission's effectiveness in reviewing telephone company rate proposals, we examined rate cases for three telephone companies: Pacific Bell, the General Telephone Company (GTC), and the Continental Telephone Company of California (Continental). The commission accepted Pacific Bell's proposal in January 1983; the GTC's proposal in July 1983, and Continental's proposal in December 1983. In 1984, these three companies represented over 98 percent of the total telephone operations regulated by the commission in California. For our analysis, we selected two of the largest accounts for the three companies--plant assets and maintenance expenses. We also reviewed the commission's audit of the three telephone companies' financial records and accounting transactions. The commission's staff engineers often have to rely on company-provided financial data that has been audited by the staff accountants.

In evaluating the effectiveness of the commission's rate case reviews, we tested the analytical and mathematical accuracy of team members' analyses and their workpapers that support these analyses. We also tested the team members' analyses for thoroughness to determine if the team members enforced the documentation requirements of the rate case plan. Finally, we analyzed the coordination of the rate case team by determining if team members knew of and used the results of other team members' analyses whenever possible.

AUDIT RESULTS

I

THE PUBLIC UTILITIES COMMISSION'S TELEPHONE RATE CASE REVIEWS ARE NOT ALWAYS WELL COORDINATED, ACCURATE, AND THOROUGH

In three rate cases that the Public Utilities Commission (commission) critically reviewed between 1983 and 1984--Pacific Bell, the General Telephone Company (GTC), and the Continental Telephone Company of California (Continental)--the commission trimmed $924 million from the $1.6 billion rate increase proposals of the three telephone companies. For plant-in-service, one of the two accounts that we reviewed, the commission reduced the revenue requested from $1.2 billion to $764 million. Similarly, the commission reduced the combined estimate for the companies' maintenance expenses from $2.1 billion to $1.8 billion. However, the commission could have reduced the combined revenue required for these items by an additional $73 million. In addition, the commission's audit staff did not thoroughly carry out their audit plans. Therefore, the commission cannot assure the necessity and reasonableness of millions of dollars of telephone company expenditures. If the commission's rate case reviews were better coordinated, more accurate, and more thorough, Californians could save additional millions of dollars in telephone rate increases.

Rate Case Managers Do Not Always Effectively Coordinate the Analyses of Rate Case Team Members

The commission's review of a company's application for a rate increase involves a comprehensive analysis of the company's estimates of revenue, operating expenses, depreciation expenses, and investment in plant and equipment. The commission assigns a team of engineers, accountants, and economists to do these analyses under the supervision of a project manager, or rate case manager. However, rate case managers do not always effectively coordinate the rate case team members' analyses. Therefore, analysts do not always use inflation factors or audit adjustments developed by fellow analysts. In addition, rate case team members do not always follow the general commission practice of using the estimates of other team members and other commission analysts in determining telephone companies' revenue requirements. In the three rate cases we reviewed, this lack of coordination resulted in the commission's overestimating the telephone companies' revenue requirement by $41.3 million.

The Function of the Rate Case Team

To review a telephone company's application, the commission establishes a team of engineers, accountants, and economists who are drawn from the various branches and sections within commission's Public Staff Division. For major rate cases, the team may include between 25 and 30 staff members, who are supervised by a rate case manager. The

rate case manager is assisted by intermediate supervisors who have direct supervisory responsibility over several analysts.

One of the rate case manager's first tasks is to assign to each staff team member a segment of the company's application to review. Typically, the engineers review a company's operating and capital expenses. For example, one staff member will be responsible for reviewing the reasonableness of a company's allowance for depreciation expenses; another will review the utility's maintenance expenses. The staff accountants audit the company's financial records and accounting transactions. This is an essential step in the commission's review since the staff engineers have to rely on the company's financial data. In addition, staff economists prepare "escalation factors" that the other members of the rate case team use. Escalation factors are the projected annual increases, caused by inflation, in particular company expenditures.

Members of the rate case staff are responsible for developing estimates in the segment of the rate case they are assigned to review. These estimates and their underlying rationale are compared to the telephone company's estimates by an administrative law judge, the commissioners, and other interested parties. In accordance with commission policy, after rate case team members develop their estimates of the telephone companies' particular asset and expense accounts, they are to provide this information to other team members. For example, the engineer responsible for estimating a company's depreciation

expense first needs to obtain from a fellow team member an estimate of the company's "plant-in-service," or plant assets. Other team members should rely on the staff economist's estimate of the number of new telephone customers when they are developing their own estimates.

The rate case managers are responsible for ensuring that each rate increase application is thoroughly and accurately reviewed and that the review is well coordinated. They devise a work plan that specifies when each staff estimate must be available to other team members. To facilitate the availability of the estimates, some estimates must be completed sooner than others. Rate case managers also schedule and hold periodic team meetings to monitor the progress of the review.

Disjointed Team Efforts

We found several instances in which rate case team members did not use each other's estimates, as the commission's policy requires. Two of the instances we identified involved the staff engineers who analyzed maintenance expenses in the Pacific Bell and the GTC rate cases. Maintenance expenses consist of costs for labor, material, administration, and other overhead expenses incurred in repairing and modifying telephone plant. The engineers who reviewed maintenance expense either did not use or did not consistently use the nonlabor escalation rates developed by a staff economist. A nonlabor escalation rate is the percentage increase in the price of nonlabor items such as

supplies or equipment from one year to the next. To determine maintenance expenses for nonlabor items, analysts use the estimates that are primarily based on previous years' expenses. Therefore, team members must use escalation rates to account for anticipated price increases from one year to the next.

The commission's staff economists determine nonlabor escalation rates that the rate case team should use in developing estimates of assets and expenses. The commission's economists and analysts review statistical data from a number of different sources and develop and use complex economic models for estimating inflation rates for utilities. The commission's economists periodically inform the rate case team of these rates through memoranda. These memoranda also include a directive from the Deputy Director of the Public Staff Division that rate case staff should use the nonlabor escalation rates included in the memoranda or obtain approval before using other rates.

In neither the Pacific Bell case nor the GTC rate case did the staff engineers who analyzed maintenance expenses or the supervisors who reviewed their work obtain approval for using nonlabor escalation rates that differed from those developed by the economists. In the Pacific Bell rate case, according to the rate case manager, the engineer who analyzed the company's maintenance expenses did not use the economists' nonlabor escalation rates because they could not be easily incorporated into the methodology the engineer chose to use in estimating the company's maintenance expenses. However, the

economists' rates could have been incorporated into the engineer's methodology if it had been slightly modified. We recalculated maintenance expenses using this modified methodology and the economists' rates and then compared our estimates with the commission's. Because the engineer did not use the economists' rates, the commission overestimated Pacific Bell's revenue needs related to maintenance expenses by $33.8 million.

In the GTC rate case, the engineer who analyzed maintenance expenses used the economists' nonlabor escalation rates for estimating only 16 of the company's 41 nonlabor maintenance item expenses. These rates were 1.7 percent for 1983 and 5.5 percent for 1984. For the remaining 25 items, the engineer told us that, based on his review of the company's expenses for these items in previous years, he concluded that the company's expense estimate was reasonable. Contrary to commission policy, the engineer did not obtain approval before accepting the company's estimates. However, the company's estimates for these 25 items included nonlabor escalation rates averaging 5.82 percent in 1983 and 9.98 percent in 1984. We recalculated the company's maintenance expenses using the economists' rates for all 41 nonlabor items. We then compared our estimates with the commission's and determined that, because the engineer did not use the economists' rates, the commission overestimated the GTC's revenue requirement by $5.9 million.

Two other examples of lack of coordination involved staff in the GTC and the Continental rate cases who failed to include in their estimates audit adjustments developed by staff auditors. In both cases, the audit adjustments would have reduced the companies' revenue requirement.

The rate case team's auditors determine and make audit adjustments after reviewing telephone companies' records and accounting transactions for compliance with the accounting procedures adopted by the commission. These auditors also determine the reasonableness of company expenditures. If the auditors find that expenditures are unreasonable or that the company has not complied with accounting procedures required by the commission, then the auditors will adjust the company's estimates to correct these problems. After making adjustments, the auditors prepare a memorandum explaining the adjustments and distribute the memorandum to all rate case staff. Because the auditors' adjustments can change a telephone company's revenue requirement, it is important that the team members incorporate these adjustments into their analyses and accurately estimate revenues, expenses, and assets.

In the GTC rate case, the staff economist who analyzed a portion of general office salaries and expenses overlooked the auditors' memorandum and, consequently, did not use the audit adjustment that would have reduced the company's revenue requirement by $1.4 million. We discussed this oversight with the rate case manager,

who agreed that it was ultimately his responsibility as team manager to assure that this audit adjustment was used in the rate case. However, according to the rate case manager, the immediate supervisor of the staff economist who overlooked the audit adjustment was transferred to another division in the middle of the rate case, consequently increasing the rate case manager's supervisory responsibilities.

A similar lack of coordination occurred in the Continental rate case when the staff engineer who compiled all the estimates of other rate case staff failed to include an audit adjustment that would have reduced the commission's estimate of the company's plant-in-service. Because the engineer did not include this adjustment in his final estimates, the commission overestimated the company's revenue requirement by $229,000. Neither the staff engineer responsible for compiling the other team members' estimates nor the rate case manager could explain how this oversight occurred.

Rate case managers are responsible for coordinating the analyses of the rate case team members to ensure that their estimates of telephone companies' revenues, expenses, and rate base are accurate and consistent with one another. However, as the above examples from each of the three rate cases illustrate, the rate case managers did not always effectively coordinate the rate case staff efforts.

During our review, we learned that the commission has a checklist that the rate case team can use when analyzing and estimating

telephone companies' assets, revenues, and expenses. This checklist is a comprehensive list of tasks that each staff engineer is to complete in reviewing a company's estimates. However, not all staff use the checklist, and some team members did not even know the checklist existed.

Rate Case Reviews Are Not Always Accurate Because of Mathematical Errors and Faulty Analyses

The analyses of the commission's rate case teams are not always accurate because team analysts make mathematical errors and make incorrect analyses. In analyzing a company's assets and expenses, team members are required to make numerous mathematical calculations. The staff compute most of these calculations manually, and in some cases they make errors. In addition, faulty staff analyses resulted in the commission's overestimating telephone companies' revenue requirements by $21.9 million. The staff's inaccurate reviews are not detected because rate case managers and supervisors do not sufficiently review staff analyses or final estimates.

Mathematical Errors

When rate case team members analyze telephone companies' rate proposals, they must review numerous documents and data, some of which they use in developing their estimates of telephone companies' assets and expenses. In addition, the staff must make complex manual

calculations when developing their estimates. Further, many staff analyses and estimates must be modified quickly during the rate case process as additional data become available.

In the accounts we reviewed, most staff made manual calculations when analyzing and estimating telephone companies' assets and expenses. Since commission staff make numerous calculations, making these calculations manually may increase the probability that staff will make mathematical errors. This problem is compounded because rate case managers and supervisors do not routinely review staff analyses and estimates for mathematical accuracy.

We identified a number of inaccuracies caused by mathematical errors in the staff analyses and estimates. Two of these errors had a significant effect on estimates of the company's revenue requirement. These two errors were made by the staff engineer who analyzed maintenance expenses in the Pacific Bell rate case. As a result of these mathematical errors, the commission overestimated the revenue requirement for Pacific Bell by $937,000.

The commission is in the process of increasing its computer resources and will have more computer resources available to rate case staff who analyze telephone companies' rate proposals. However, the commission has no objective criteria for determining the computer needs of its various offices and divisions and, therefore, cannot assure that telephone rate case teams will have sufficient computer resources to

accurately and thoroughly analyze telephone companies' assets and expenses.

Faulty Analyses

Staff reviews of historical telephone company data are the basis upon which all of their final rate case estimates are determined. The rate case teams frequently use complex methodologies when they are conducting their analyses. These analyses require them to review numerous telephone company documents and to use the historical data to estimate the company's future expenses.

For example, when estimating maintenance expenses, staff engineers must estimate both labor and nonlabor expenses. To estimate labor expenses, the engineers determine the number of hours that are required to maintain the company's machines and equipment. For major telephone companies, the total number of hours of maintenance work is frequently in the millions of hours. Since this total depends on the size of the plant and the amount of equipment that a company must maintain, total number of hours of maintenance work is estimated by first determining the extent of a company's plant and equipment. Therefore, knowing the number of telephone lines and estimating how many customers are expected to join or leave the company's network in a given year are essential steps in estimating maintenance expenses. Nonlabor maintenance expenses are estimated a little differently. Staff engineers review actual company expenses, determine a reasonable

expense level for each nonlabor item, and then multiply this amount by an inflation factor or escalation rate.

We found several instances in which the staff's analyses were not accurate. For example, the staff engineer who analyzed maintenance expenses in the GTC rate case did not always accurately determine to which of the company's expenses he should apply the staff economist's estimate of nonlabor escalation rates. Consequently, in developing his maintenance expense estimates, the staff engineer sometimes used the company's rates when he should have used the rates developed by his staff economist. As a result, the commission overestimated the GTC's revenue requirement by $10.3 million.

In another instance, the staff engineer who reviewed maintenance expenses in the Pacific Bell rate case did not accurately analyze the company's historical data that specified the number of labor hours recorded for each maintenance account. The engineer analyzed recorded, or historical, labor hours in order to develop an estimate of labor hours in the "test year"--the year upon which the company bases its justification for an increase. He used test-year labor hours as the basis for his estimate of the company's labor expenses. However, the engineer included some labor hours in his analysis and labor expense estimate that he also included in a nonlabor item expense estimate. As a result, the staff engineer counted some hours twice. Consequently, the commission overestimated the company's revenue requirement by $8.8 million. This engineer made another

analytical error when estimating labor hours for one maintenance account by incorrectly including hours for Pacific Bell employees who had been transferred to the American Telephone and Telegraph Company. This error resulted in the commission's further overestimating the company's revenue requirement by $1.9 million.

In both the Pacific Bell and the GTC rate cases, the supervisors of the staff engineers who analyzed maintenance expenses were familiar with the engineers' analysis plans but did not identify the inaccuracies in the plans.

The Reviews of Telephone Company Rate Proposals Are Not Always Thorough

The commission overestimated two companies' revenue requirements by $9.6 million because it based its decisions about increase proposals on information that was not always complete. The telephone companies are not sufficiently documenting their need for rate increases, and the commission's auditors are not thoroughly reviewing telephone companies' accounting records.

Although the commission has established specific requirements for the major telephone companies to follow in demonstrating or documenting their need for a rate increase, the commission does not always enforce these requirements. Further, three of California's telephone companies are not covered by these or any other documentation requirements. The commission's accountants audit the company's

financial records and accounting transactions to test the reliability of the company's financial data, the reasonableness and necessity of the company's expenditures, and the company's compliance with commission policy regarding revenues and expenses. However, even though the commission has established audit programs that its auditors must use to examine a telephone company's financial records and accounting transactions, the auditors are not thoroughly completing these audit programs in conducting their reviews. If a company's application for a rate increase is not well documented and if its records are not thoroughly audited, the commission cannot ensure the necessity and reasonableness of the company's need for a rate increase.

Of the 22 telephone utilities in California, only Pacific Bell and the GTC are subject to the commission's rate case plan, which establishes the schedule for processing formal rate cases and the requirements that companies must follow in applying for a rate increase. Because the rate case plan may not be appropriate for the smaller California telephone companies, the commission has established an abbreviated procedure which the smaller companies may use to apply for a rate increase. This abbreviated procedure is referred to as an "advice letter" application and is outlined in the commission's General Order 96-A. If the smaller California telephone companies elect not to file an application according to the commission's General Order 96-A, they may file a formal rate increase application.

The Rate Case Plan

To ensure that the rate increase applications of Pacific Bell and the GTC are expeditiously processed and sufficiently documented, the commission has established a rate case plan to process these companies' rate increase proposals. The rate case plan sets forth the schedule for processing a formal rate case and the requirements that a company must follow in applying for a rate increase. Although several California companies file formal rate increase proposals, Pacific Bell and the GTC are the only telephone companies for which the commission requires adherence to a rate case plan.

When a telephone company seeks a rate increase, it must demonstrate its need for higher rates in its rate increase proposal. The rate case plan specifies the documentation standards that the commission requires a company to follow in justifying its need for a rate increase. The rate case plan requires that the company submit final exhibits such as cost studies, historical data, and account estimates. All of these exhibits must be documented by supporting workpapers. A company may also submit testimony with the rate increase proposal. In addition, the rate case plan requires a company to support any revisions to the rate proposal with documentation and to reconcile any revised figures to the workpapers previously submitted. The rate case plan requires the company to submit a well-documented rate increase proposal to justify its need for additional revenue.

According to the rate case plan, the telephone company must prepare workpapers that detail how the company derived each estimate in its application. The company's workpapers must explicitly state each of the assumptions that the company makes in deriving these estimates. Also, the company must show how each assumption is used in these estimates. If there is no objective basis for the company's estimate and the company arbitrarily arrived at its estimate, this fact must be stated in the workpapers.

Insufficient Documentation

During our review of three telephone company rate cases, we found four instances in which commission staff did not require telephone companies to provide sufficient documentation to support their proposed rate increases or did not require the companies to justify revisions made to the rate increase proposals. For example, in the GTC rate case, the staff engineer who analyzed plant-in-service accepted a revision to the company's plan to modernize its switching offices without thoroughly reviewing the revised plan. In addition, the engineer did not thoroughly review a second revised plan that the company submitted to the commission. This lack of thoroughness resulted in the commission's adopting a higher estimate of plant-in-service than was reasonable.

The GTC planned to update its switching offices by installing digital switches, a more modern type of telephone switching equipment

than that previously in place. In addition to enabling a central office to provide custom calling features such as call forwarding or speed dialing, these up-to-date switches use less power and cost less to maintain. The GTC planned to convert 11 offices in 1983 and 16 offices in 1984. However, because of manufacturer's delays, the conversion process did not stay on schedule. Based on his knowledge of these delays, the commission staff engineer developed his estimates of plant-in-service and proposed to reduce the GTC's rate base estimate by $38.4 million. This proposal would reduce the GTC's revenue requirement by $7.6 million. In developing this adjustment, the engineer assumed that the GTC would be delayed 3 months in converting the remaining central offices it planned to convert. At the time the engineer developed this adjustment, the average delay was 4.5 months. The engineer made the adjustments because the GTC could not include the costs of modernizing these central offices in its rate base until the GTC could demonstrate that these offices were actually going to be serving customers.

Late in the rate case, the staff engineer received from the GTC a revised conversion schedule that specified the company's actual central office conversion dates in 1983 and anticipated conversion dates in 1984. The staff engineer recommended that the commission adopt a lower central office conversion adjustment of $15.6 million based on the company's revised conversion schedule. The commission adopted this recommendation.

However, we determined that the GTC submitted two different schedules: one schedule to the commission as evidence during a public hearing and another schedule to the staff engineer. The engineer's recommended adjustment was based on the schedule he received. However, the schedule submitted to the staff engineer showed less average delay for the remaining 1984 central office conversions than the schedule that the GTC submitted to the commission as evidence during public hearings. The length of the delay between the company's original completion date and the anticipated conversion date was a key factor in the adjustment the engineer recommended the commission adopt. The shorter the delay, the smaller the adjustment would be.

We disagree with the conclusion the engineer reached concerning the reasonableness of the revised conversion schedule upon which he based his revised adjustment. In 1983, when the engineer calculated his original adjustment of $38.4 million, the average delay for central office conversions was 4.5 months. In April 1984, when the company submitted its revised conversion schedules, the GTC's average delay for all of its conversions to date was 2.6 months. However, the revised conversion schedule from which the engineer determined his $15.6 million adjustment was based on an average delay of only 1.3 months for the GTC's remaining digital conversions in 1984. The revised conversion schedule that the GTC submitted as evidence during the commission's public hearing was based on an average delay of 1.8 months. Based on this conversion schedule, we recalculated the central office conversion adjustment to be $19 million.

Based on the GTC's central office conversion history through March 1984, we conclude that the average conversion delay in the revised conversion schedule that the GTC provided to the staff engineer was not reasonable. At a minimum, the engineer should have recommended an adjustment based on the more reasonable revised conversion schedule that the GTC submitted to the commission during its public hearing. Because he did not do this, the commission overestimated the GTC's rate base by at least $3.4 million, and, therefore, overestimated the company's rate increase by $675,000.

In another instance, the commission's staff engineer who reviewed the GTC's advertising expenses revised his estimates based upon information he received in a telephone conversation with a company official. The staff engineer did not request any documentation from the company to support the information he received during the telephone conversation. As a result, the commission allowed $1.2 million of rate increase to remain in the rate increase proposal without proper justification from the GTC.

In addition, the commission accepted revisions to financial data that Pacific Bell had filed earlier in its rate case without requiring that the company submit any documentation explaining these revisions. In this case, Pacific Bell initially submitted cost data to the commission on the total amount that it had charged to a particular account for payments the company made to employees participating in an early retirement program. Later in the rate case, Pacific Bell revised

the cost data that it originally submitted, stating that it had made an error in compiling the original information. The ultimate effect of this revision was an increase in Pacific Bell's proposed rates. In spite of this increase, the commission's staff engineer did not question this change. Nor did the staff engineer require that the company submit documentation to back up the accuracy of the revised cost data. Because the staff engineer did not require Pacific Bell to provide such documentation, the commission allowed $7.7 million to remain in the rate increase proposal without required justification.

In the three examples we discussed above, the commission allowed $9.6 million to remain in the two companies' rate increase proposals without proper justification. Although we were able to determine that the need for these expenditures was not sufficiently documented, we did not extend our audit work to test the reasonableness of these projected expenditures.

Incomplete Audits

During each rate case, the company provides financial and operating data to commission engineers who rely on this data to derive their estimates of company revenues, expenses, and assets. Commission auditors audit the companies' financial data to assure the reliability of this data. However, we found that some of the auditors are not thoroughly carrying out their audit plans. In all three rate cases, the staff auditors failed to completely review the companies' assets,

revenue, and expense items included in their audit plans. Furthermore, the auditors did not always explain why they did not completely review these items. The commission's principal auditor agreed that, when an auditor does not complete an audit step, the auditor should justify in writing the reasons for not completing the step.

In the Pacific Bell rate case, the auditor who reviewed Pacific Bell's operating revenues did not complete all the audit steps included in the audit plan. The audit plan required the auditor to select a sample of items from a billing cycle and perform a detailed analysis to determine if the company's operating revenues were fairly stated. In addition, the audit plan required the auditor to review the company's procedures for handling unbilled revenues and contested billings. However, the auditor did not complete these audit steps when he reviewed Pacific Bell's operating revenue account. Instead, the auditor analyzed the operating revenue accounts and selected only one account for a detailed review. Furthermore, the auditor did not document his justification for not completing all of the audit steps specified in the audit plan.

We also found one instance in which commission auditors completed the audit steps but did not sufficiently review the company records and accounting transactions associated with the specific audit steps. In the Continental Telephone Company (Continental) rate case, the auditors reviewed the company's "traffic expenses." Traffic expenses are the salaries, wages, and overhead costs associated with

the handling of telephone calls by switchboard operators and the costs associated with monitoring the performance of the switching network. The commission's audit plan required the auditors to select a sample of the traffic expenses to determine if the costs incurred were reasonable. Since the majority of the traffic expenses incurred by Continental are included in the operators' wages account, the auditor should have reviewed a substantial sample of the employees' timesheets, which are the main source of documentation for the operators' wage expenses. However, the auditor reviewed only one out of approximately 400 employee timesheets. Drawing conclusions based on a 90 percent confidence level would require reviewing a sample of 66 of the 400 timesheets. We conclude that the auditor did not sample enough employee timesheets to determine with significant confidence the necessity and reasonableness of the company's traffic expenses.

In the GTC rate case, the auditors did not thoroughly review the cost reasonableness of company purchases in 1982 of four central office electronic switches even though the audit plan stated that the auditors would perform such an analysis. Electronic switches are an important part of a telephone company's network; they process, connect, and complete calls. Although electronic switches cost millions of dollars, the commission did not require the company to use competitive purchasing practices for central office switching equipment until 1985, after these switches were purchased. Consequently, it was important that the auditors thoroughly review the cost of the switches. However,

the auditors did not review the reasonableness of the purchases and could not assure the commission that the GTC's expenditures for this equipment were reasonable.

We found other instances of incomplete reviews of telephone companies' assets and expenses in both the GTC and the Continental rate cases. In these rate cases, the audit plans required auditors to perform "fluctuation analysis." Fluctuation analysis is a standard analytical technique that commission auditors use to isolate accounts that show unusual fluctuations in activity from one period to the next. Because of their unusual fluctuations, these accounts are reviewed in greater detail. After reviewing the fluctuation analyses, the auditors do more detailed analyses to determine the causes of the fluctuations.

In both rate cases, the commission's auditors made fluctuation analyses of major accounts and identified significant fluctuations in these accounts. However, the auditors did not always follow up with detailed analyses to determine the causes of the large fluctuations. For example, in the GTC rate case, the auditor's fluctuation analysis indicated that executive salaries increased an average of 25 percent each year between 1980 and 1982. Another auditor's analysis of the material and supplies account showed that this account fluctuated up to 429 percent from one year to the next. In both cases, the auditors failed to perform detailed analyses to determine the causes of the fluctuations.

Similarly, in the Continental rate case, the auditor who reviewed traffic expenses made a fluctuation analysis that showed that one subaccount increased 47 percent from 1981 to 1982 and 114 percent from 1982 to 1983. Again, the auditor who performed the fluctuation analysis did not further analyze the account to determine the cause of the fluctuation.

According to the commission, the auditors did not further analyze these accounts because of time constraints. We recognize that commission auditors cannot review every account; however, the auditors have already limited the amount of work they plan to do by selecting only certain accounts to review. In selecting those accounts that warrant a detailed review, the auditors develop fluctuation analyses. However, although the auditors develop these fluctuations to isolate specific accounts, the auditors do not always perform detailed analyses of these accounts. When the rate case auditors do not analyze accounts that show large fluctuations from one year to another, the commission cannot assure the necessity and reasonableness of millions of dollars of telephone company expenditures.

Since we were auditing the commission, not the three telephone companies, we did not extend our audit work to a review of the telephone companies' financial records and accounting transactions. Therefore, we do not make any conclusions about the propriety of the companies' financial records and accounting transactions. Rather, we have concluded that the commission's audits are not always thorough

and, therefore, do not provide sufficient assurance that the financial and operating data that the companies provide to the commission during the rate case are reliable.

Telephone Companies With No Documentation Requirements

Not all telephone companies are subject to written requirements that specify the documentation necessary to support their proposed rate increases. Consequently, the commission cannot always ensure, as the Public Utilities Code requires, that the rates it adopts exclude all costs that are unreasonable or unjust.

Three telephone companies operating in California--Continental, Citizens Utilities, and Roseville Telephone Company--are not required to follow either the rate case plan or General Order 96-A. The remaining 17 smaller companies may elect to either follow the General Order 96-A procedures or file a formal rate increase application. If the companies choose to file a formal rate increase proposal, they are not subject to any written documentation requirements. As a result, these 17 smaller companies may fall into the same category as Continental, Citizens Utilities, and Roseville Telephone Company with no documentation requirements to follow.

If companies are not required to provide documentation to support the proposed rate increases, the commission cannot ensure that the rates these companies propose are reasonable. For example, in the

Continental rate case, the commission staff engineer who reviewed maintenance expenses did not thoroughly review the wage rates for maintenance employees. Wage rates are a basic item used in estimating a company's maintenance expenses and should be well documented. In the Continental rate case, the company did not provide the staff engineer with any documentation supporting maintenance employees' wage rates. Consequently, to develop his labor expense estimates, the staff engineer used a wage rate figure he received during a telephone conversation with a company official.

Furthermore, documentation that the company provided when the rate case staff requested it was not adequate for the staff to readily analyze. In one instance, the staff engineer requested data specifying the number of hours Continental's maintenance employees worked in California in previous years and the labor expenses associated with this work. The staff engineer also requested the company's estimates of these items for the current year and the following year. In both the GTC rate case and the Pacific Bell rate case, this documentation was readily available for the staff engineers who reviewed the company's maintenance expenses. However, Continental did not provide the requested data to the staff. Instead, the company provided the staff engineer with similar data for its total company operations, which include Nevada and Arizona. As a result, the staff engineer had to spend at least 40 hours isolating the data for the company's California operations before he could begin his analysis of maintenance expense.

Concluding that the full rate case plan was probably not appropriate for telephone companies other than Pacific Bell and the GTC, the commission followed a modified version of the rate case plan to process the rate cases of the three companies not subject to either the rate case plan or the General Order 96-A procedures. The commission did this to have some standards to follow in processing these companies' rate cases. For two of these three companies, this arrangement was satisfactory. However, Continental did not sufficiently document its last rate increase proposal, making it more difficult for the commission to evaluate the company's need for a rate increase.

CONCLUSION

Although the commission reduced the revenue requested by the three telephone companies whose rate cases we reviewed--Pacific Bell, the General Telephone Company, and the Continental Telephone Company of California--the commission could have made further reductions of $73 million if its rate case reviews were well coordinated, accurate, and thorough.

Rate case managers are responsible for coordinating the efforts of the rate case team. However, we found numerous instances in each of the three rate cases in which the rate case manager did not do this. As a result of inadequate

coordination, the commission overestimated the revenue requirements for the three telephone companies we reviewed by $41.3 million.

The commission has developed a checklist for staff to use when analyzing and estimating a company's rate increase proposal. This checklist could aid rate case managers in assuring that the efforts of the rate case staff are well coordinated. However, not all team members are using this checklist.

In addition, the rate case staff analyses are not always accurate; they include mathematical and analytical errors. We identified inaccuracies in the staff's analyses that resulted in the commission's overestimating the revenue requirements for the three telephone companies we reviewed by $21.9 million. The mathematical errors could be minimized if staff had computer resources more readily available. Both the mathematical errors and the analytical errors could be reduced if rate case managers and supervisors more thoroughly reviewed the staff's analysis plans and final estimates.

Although the commission has developed specific requirements that the major telephone companies have to follow in demonstrating or documenting their need for a rate increase, the commission does not always require that the companies adhere to these requirements. As a result, the commission

overestimated the revenue requirements for the three telephone companies we reviewed by $9.6 million. Further, three of California's telephone companies are not covered by these or any other documentation requirements. If a company's application for a rate increase is not well documented, the commission cannot thoroughly assess the company's need for a rate increase. Also, although the commission has established audit programs that its auditors can use to examine a telephone company's financial records and accounting transactions, the auditors are not thoroughly completing these audit programs in conducting their reviews.

RECOMMENDATIONS

To improve the coordination of the rate case team's efforts, rate case managers and supervisors should more thoroughly review staff analyses to ensure that staff use each other's estimates whenever possible. In addition, the division should require that staff use the checklist that the commission developed for analyzing telephone companies' rate increase proposals. The checklist specifies tasks that staff should complete when analyzing proposals, such as coordinating with other staff and reviewing the staff auditors' adjustments.

To improve the accuracy of team members' analyses, the commission should review the computer resources currently

available to its telephone rate case teams and determine if more resources are necessary. In addition, the commission should implement a system to ensure that rate case managers adequately review team members' analyses and estimates.

To improve the thoroughness of team members' analyses, the rate case managers and supervisors should increase their review of staff analyses to ensure that staff are enforcing the documentation requirements of the rate case plan. In addition, the managers and supervisors should require the commission's auditors to complete all the steps included in their audit plan or to document their justification for any of the audit steps they do not complete. Further, the commission should develop and enforce minimum documentation requirements for the three telephone companies that are not currently covered under the rate case plan or General Order 96-A. The commission should develop and enforce minimum documentation requirements for the 17 telephone companies that have an option to apply for rate increases under the abbreviated advice letter procedure or through a formal rate increase proposal. When these companies elect to file a formal rate increase proposal, the commission should require that these companies submit documentation that thoroughly supports the need for a rate increase.

II

THE PUBLIC UTILITIES COMMISSION MISSED AN OPPORTUNITY TO REDUCE ONE COMPANY'S TELEPHONE RATE INCREASE PROPOSAL

In the Pacific Bell rate case that we reviewed, the commission found that Pacific Bell had more rate base than it needed to adequately serve its customers. Because of this inefficiency, the commission reduced Pacific Bell's rate request by $47.5 million. The commission staff conducted their review of the General Telephone Company (GTC) rate proposal after completing their review of the Pacific Bell proposal. However, the staff did not review the adequacy of the GTC's rate base and missed an opportunity to save GTC ratepayers at least $30 million.

In addition to assessing the reasonableness of a telephone company's operating expenditures, the commission is responsible for reviewing the company's "rate base"--the value of the plant and equipment a company uses to provide telephone service to its customers. A company's rate of return is expressed as a percentage of its rate base. For telephone companies, the rate base includes such items as land, buildings, cables, poles, microwave towers, and telephone switching equipment. The commission evaluates the company's rate base to ensure that it is reasonable, given the number of customers that the company serves.

In 1983 the Commission Penalized Pacific Bell for Having an Excess Rate Base

In the commission's 1983 report on Pacific Bell's operations, the commission concluded that Pacific Bell was not adjusting its construction expenditures in response to a reduced need for new telephone lines. The commission staff compared Pacific Bell's budgeted and actual construction expenditures to the number of new telephone lines placed into service between 1978 and 1983. The commission pointed out that between 1980 and 1982, the need for new telephone lines was decreasing while Pacific Bell's construction budget was either increasing or remaining constant. The commission concluded that Pacific Bell had not acted promptly in cutting back its construction program in response to a declining need for new telephone switching equipment and outside plant.* The commission found that Pacific Bell had purchased and installed more capital equipment than it needed to adequately serve its customers.

Since Pacific Bell was underusing these facilities, the commission concluded that some of Pacific Bell's investment in these facilities should be excluded from its rate base. Therefore, the commission made a $47.5 million reduction to Pacific Bell's rate increase proposal.

*Telephone switching equipment is used to make connections between one telephone and another and between one switching office and another. Outside plant includes the facilities that connect telephone switching offices to the customer or to other switching offices. Typical items of outside plant are poles, wires, underground lines, and conduit.

In reviewing Pacific Bell's rate increase proposal, the commission demonstrated that Pacific Bell was underusing its plant and equipment by comparing the capacity of Pacific Bell's switching equipment and outside plant with the company's use of this equipment. For example, the commission found that Pacific Bell used an average of only 88 percent of its switching capacity in 1982. The commission recognizes the need to hold some capacity in reserve and, therefore, does not expect use to equal capacity. However, the commission did expect Pacific Bell's use of its switching equipment to more closely approach capacity. In its decision, the commission concluded that Pacific Bell should be using approximately 91.5 percent of its capacity. Concluding that Pacific Bell's underuse of its switching equipment would continue into 1983 and 1984, the commission decreased Pacific Bell's proposed rate increase by $47.5 million.

The Commission Overlooked An Inefficient Condition at the General Telephone Company

The commission processed the GTC's rate case after Pacific Bell's. More specifically, the commission staff conducted their review of the GTC rate proposal after completing their review of the Pacific Bell proposal. Information that was available during the rate case review, between May 1983 and July 1984, indicates that the GTC also had a higher rate base than it needed to adequately serve its customers. However, the commission did not reduce the GTC's rate proposal as it did Pacific Bell's.

From 1980 to 1982, the GTC's use of its switching offices decreased from 90 percent to 83 percent of capacity. Furthermore, the company projected a continuing decline in use to an estimated 81 percent of capacity by 1984. Even the GTC recognizes that a reasonable usage rate would be in the 92 to 95 percent range. Relying on the same assumptions, cost data, and estimating techniques that the commission used in the Pacific Bell rate case, and assuming that the GTC's usage rate should be 90 percent of capacity, we estimated the extent and the value of the GTC's excess capacity. Our calculations show that the commission missed the chance to reduce the GTC's proposed rate increase by at least $30 million.

The GTC recently initiated a program to more closely scrutinize the use of its switching equipment. Hoping to save millions of dollars over the next few years and also avoid a penalty similar to that levied against Pacific Bell for underusing its assets, the GTC's program is aimed at more efficient use of its switching equipment.

Commission officials have given us several reasons for not investigating the GTC's underuse of its switching equipment as it did Pacific Bell's underuse. The GTC's past service problems and the commission's time and staff limitations were all cited as reasons for not investigating this issue. The rate case manager for the GTC rate case pointed out that the GTC had a history of providing poor service, which the commission determined may have been caused by the GTC's overusing rather than underusing its switching facilities. In past

rate cases, the commission had admonished and eventually penalized the GTC for providing poor service to its customers.

The rate case manager also cited the limited amount of time allotted to rate case reviews as a reason for not investigating this issue. Rate case team members now have approximately 4.5 months to analyze the company's actual and recorded revenues, expenditures, and rate of return; to investigate the efficiency of the company's operation; and to evaluate the quality of the company's service before they have to write a report on their findings.

Finally, the rate case manager for the GTC rate case cited inexperienced staff as a reason for not reviewing the efficiency with which the GTC was using its switching facilities. The staff member who had been assigned to review this portion of the GTC's rate base was new to telephone company rate case work and, according to the rate case manager, had not yet acquired the expertise necessary to effectively review an issue as new and as controversial as this one.

We do not believe that the commission has a justifiable rationale for not investigating the GTC's underuse of its switching equipment. In the first place, the rate case manager made a decision on this issue without analyzing any available data on the GTC's use of its switching equipment. We obtained these data, which had been available when the commission was processing the rate case, and presented it to the rate case manager. The data showed that the GTC

was using only 83 percent of its switching equipment in 1982; a reasonable level of use would have been 92 to 95 percent. After reviewing the data, the rate case manager expressed concern over the GTC's excess switching equipment.

Furthermore, the GTC had improved its service since the commission had imposed a monetary penalty on the GTC in its 1982 rate case. In the 1984 rate case, the commission recognized the improvement that the GTC had made in improving its service by partially lifting the penalty it had imposed earlier for overuse of switching equipment.

The GTC rate case manager also cited the time limitation as a reason for the commission's not investigating the GTC's underuse of switching equipment. However, the same time limitation existed when the commission processed the Pacific Bell rate case. In that case, as we have pointed out, the commission did investigate the company's underuse of switching equipment.

We also believe that the assignment of inexperienced staff to a major rate case does not justify the rate case manager's decision not to investigate this issue. Although the commission has limited the amount of time that it allows itself for processing rate cases, the commission has greater flexibility in adjusting staff assignments to the needs of each rate case. The assignment of particular staff to a rate case can be a key consideration in the selection of issues to investigate.

When the GTC rate case was being processed, the commission had no formal process in which the rate case manager consulted with senior management to identify which issues to investigate during a rate case. The staff members we spoke to stated that the commission allows its rate case managers and staff considerable freedom in deciding the issues to investigate. Since it processed this rate case, the commission has taken steps that may help it to avoid omitting an important issue from a rate case review in the future. The commission has increased the involvement of its senior management in rate case decisions. In April 1985, the director of the commission's Public Staff Division directed rate case managers to more closely consult with senior management in deciding issues to study during a rate case. Rate case managers must submit to senior management a "scoping memo," which identifies the major issues that the rate case managers propose investigating during a rate case. In addition, the division director recently reestablished a telecommunications management committee, with representatives from throughout the division. This committee's function is to coordinate various units within the commission that participate in telephone rate cases, to assist the commission's senior management in addressing workload issues, and to formulate a commission stand on new telecommunications issues as they surface. However, selecting the issues to pursue during a rate case still ultimately rests with the rate case manager.

CONCLUSION

The commission missed an opportunity to save the General Telephone Company's ratepayers at least $30 million in rate increases associated with the GTC's overinvestment in rate base. At the time of this rate case, the commission had no formal process requiring the rate case manager to consult with senior management to identify which issues to investigate during a rate case. However, since then, the commission has made two changes to increase the involvement of its senior management in these decisions. First, rate case managers are now required to consult with senior management before deciding on issues to be developed during a rate case. Second, the commission has reestablished a telecommunications management committee that meets weekly to discuss a number of items, including which issues to pursue during a rate case. The ultimate decision on which issues to pursue in a rate case still rests with the rate case manager.

RECOMMENDATION

To ensure that all important issues are consistently and thoroughly considered in all rate cases that come before the commission, we recommend that the telecommunications management committee decide which issues to investigate during a rate case.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

THOMAS W. HAYES
Auditor General

Date: October 21, 1985

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Public Utilities Commission

STATE OF CALIFORNIA

FILE NO.

October 11, 1985

Thomas W. Hayes, Auditor General
660 J Street, Suite 300
Sacramento, CA 95814

Dear Mr. Hayes,

We have read your draft report, and although the limited comment time you have given us does not allow for a formal Commission response, we offer the following:

We agree with some parts of the report and disagree with others. But overall we believe the draft to be so incomplete and therefore misleading that it should not be released without substantial revision. 1 *

First, what we agree with. We agree with you that the skill and hard work of our staff enabled the Commission to cut three telephone rate requests by almost $1 billion. Although the report does not say so, the staff members working on these complex cases had to complete an enormous amount of analysis in a very short time. We agree that during times of such pressure, mistakes can occur, and we work continually to minimize them. We also agree that adequate supervision and coordination are essential to good staff work. We have made substantial improvements in this area during the past 18 months, and we will keep trying to do better. 2

Next, what we disagree with. The report is narrow and incomplete. The draft omits key facts and thus could lead readers to incorrect conclusions. For example, the report does not make clear the tight time pressures of our rate-case processing--time schedules demanded by the Legislature in the mid-1970s. Our auditors, economists, and engineers work under the pressure of

*The Auditor General's comments on specific points contained in the commission's response begin on page 57.

short deadlines. Staff members and their supervisors have to make judgments every day as to which issues they can cover thoroughly and which they will have to leave for later investigation. I wish we had enough staff to cover every issue in the detail with which your auditors reviewed our work, but we don't. 3

The report also omits important facts about our auditing staff. For example, we have difficulty retaining experienced auditors because private industry offers them higher pay than the state does. When we lose key people in the midst of audits the quality of our work can suffer. We would thus welcome your support in achieving more competitive pay for our auditors.

We also disagree with the report's conclusion that General Telephone rates could have been reduced a fraction if only the staff had made a few simple calculations. This issue involves General's investment in modernized equipment to improve service. At the very least, any such staff proposal would have been vigorously contested by the company, and the Commission might or might not have agreed with the staff. (The report is often confusing on how decisions are made: the staff recommends, but the Commission, after formal public hearings at which all proposals can be cross-examined, decides). Also, it's just plain wrong to assume, as the report does, that calculations made about Pacific Telephone could have been automatically transferred to General, when in fact the companies have different kinds of equipment.

But most important, the report deals much too lightly with the Commission's orders in recent years for General to modernize and improve service. The report implies that the Commission's sole concern is with rates. In fact, the Commission is equally concerned that utilities provide good service. This is not an invitation to unnecessary investment. But the report should make clear that after having penalized General for under-investment, the Commission would look very carefully at any staff proposals to now penalize General for too much modernization. 4

Finally, the most misleading part of the report. The report dwells almost entirely on issues that involve relatively small amounts of money, but skips quickly over issues that can mean billions of dollars in future telephone rates. We agree that rates should not be a penny higher than they need to be. But the Commission has to concentrate its limited resources on issues of the largest financial impact. 5

The report lists some of the new issues in telecommunications that now confront the Commission. But the listing does not begin to explain the impact of these issues on telephone rates. These are questions and controversies that result from the breakup of the Bell System, and from the nationwide movement away from telephone service provided almost entirely by state-regulated monopolies to service provided partly through monopolies and partly through free-market competition. 6

At stake is the potential for shifting billions of dollars in costs away from large users of the telephone network to residential and small-business users. In response, the Commission has directed its staff to give top priority to these rapidly-changing, big-dollar issues. This has necessarily reduced some staffing on traditional rate cases. And yet, as the report points out, even under these difficult conditions the staff was able to provide information and analysis that made it possible for the Commission to cut almost $1 billion from three rate requests that totaled $1.6 billion.

In short, the report's failure to explain the major issues, and to emphasize their importance to telephone rates, leaves the report incomplete and therefore misleading. The only solution is to withdraw the present draft and rewrite it to provide a full picture. Otherwise, the report should carry a consumer notice: "Warning: Reading this report will be hazardous to your understanding of telephone rates." 7

Very truly yours,

Joseph E. Bodovitz

JOSEPH E. BODOVITZ
Executive Director

cc: Commissioners

AUDITOR GENERAL'S COMMENTS ON THE PUBLIC UTILITIES COMMISSION'S RESPONSE

1 The commission's response indicates that our draft is incomplete and therefore misleading. For reasons that we discuss in detail below, we disagree with this contention. In fact, the report thoroughly summarizes the findings resulting from our examination of the commission's work on three telephone company rate increase proposals. These three companies represent a vast majority of the local telephone operations regulated by the commission in California. We found that, if the commission had more effectively reviewed the rate cases of Pacific Telephone, the General Telephone Company, and the Continental Telephone Company in 1983 and 1984, the commission could have saved the ratepayers an additional $103 million. The commission's response does not provide sufficient evidence to refute or deny any of the findings and recommendations.

2 In the second sentence of this report, we clearly credit the commission with trimming $924 million from three rate increase proposals. However, we go on to point out that had the commission more effectively reviewed the two largest accounts in these rate increase proposals, the commission could have trimmed an additional $103 million.

3 The commission's response states that our report is "narrow and incomplete" and that the report does not make clear the time pressures of the commission's rate case plan. Our report is not narrow and incomplete. On page 11, we point out that our review included the rate cases for three companies that represent over 98 percent of the total telephone operations regulated by the commission in California. On page 47 of the report, we point out that the commission staff have about 4.5 months to complete their analyses. We also point out on page 38 that the commission staff do not always require the companies to thoroughly document their need for a rate increase. This lack of documentation makes it even more difficult for the staff to review the companies' rate increase proposals within the time allotted.

4 Responding to our finding that the commission overlooked an inefficient condition at the General Telephone Company, the commission states that "the report deals much too lightly with the commission's orders in recent years for General Telephone to modernize and improve service." On page 46 of the report, we point out that the commission cited the GTC's past service problems as a reason for not investigating its overinvestment in telephone equipment. However, this explanation does not justify the fact that the commission overlooked data which showed that the GTC was using only 83 percent of its switching equipment when even the GTC recognizes that the rate should be 92 percent to 95 percent. We also point out on page 46 that the GTC recently initiated a program to more closely scrutinize the use of its switching equipment.

(5) The commission indicates that the report dwells on issues involving small amounts of money but skips quickly over issues that can mean billions of dollars in future telephone rates. On page 11, the report points out that the scope of our review was limited to an examination of the last rate increase proposals of Pacific Bell, General Telephone, and Continental Telephone companies. In 1984, these three companies represented over 98 percent of the total telephone operations regulated by the commission. In the rate cases that we reviewed, the three companies requested $1.6 billion in rate increases, were denied $924 million, and could have been denied an additional $103 million. In our judgement, none of these figures represents a "small amount of money."

(6) We discuss other telecommunications activities of the commission on pages 7 through 10 of the report.

(7) The commission believes its top priority is to prevent unfair shifts in costs from large users to small users. Although this is an important issue, the commission must deal with the more fundamental issue of what the ultimate rates should be for all users. It is unfair to both large and small users to pay excessive rates. As we point out in the report, a more thorough evaluation of rate proposals would have saved ratepayers $103 million. The commission does not provide sufficient evidence to refute or deny any of our findings and recommendations.

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps